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**EX PARTE**

Ms. Marlene H. Dortch  
Secretary  
Federal Communications Commission  
The Portals  
445 12<sup>th</sup> St. SW  
Washington, D.C. 20554

**Re: CC Docket 96-98**

Dear Ms. Dortch:

On April 22, 2003, the following persons representing BellSouth met with FCC staff to discuss UNE pricing issues: Pete Martin, Lisa Brooks, Daonne Caldwell, Jon Banks, Don Barbour and the undersigned. Attending for the Commission were Tamara Priess, Steve Morris, Chris Banekov, Jeremy Marcus and Alvaro Gonzalez. The attached presentation formed the basis of this discussion.

Sincerely,



Glenn Reynolds

cc: Tamara Priess  
Steve Morris  
Chirs Banekov  
Jeremy Marcus  
Alvaro Gonzalez

# TELRIC Pricing NPRM

BellSouth Presentation  
April 22, 2003

# TELRIC PRICING

## **WHAT CONGRESS INTENDED:**

- Uniform, cost-based pricing principles
- UNE rates that recover cost plus profit
- UNE rates that support facilities-based competition
- UNE rates that drive retail prices toward cost

## **WHAT ACTUALLY OCCURRED:**

- Inconsistent interpretation and application of TELRIC principles by state commissions
- Bias toward understated costs; UNE rates that do not even recover cost, and certainly do not include a profit; ILECs subsidizing CLECs
- UNE rates so artificially low that few carriers are interested in true facilities-based competition
- In the absence of retail rate rebalancing, geographic deaveraging of UNE rates simply created increased margins for CLECs in urban areas and a lack of competitive alternatives for customers in rural areas

# TELRIC PRICING

- Artificially low UNE rates result in CLECs being subsidized by ILECs
  - ILECs incur all the risk, all the capital expenditures, and all the maintenance expenses
  - ILECs retain carrier of last resort obligations while CLECs are free to “cherry-pick” their customers
- Calculating UNE costs in an unrealistic manner that results in costs that are too low ensures that there will NEVER be a carrier that can serve customers more “efficiently” than the ILEC
- The abundance of unused switches is proof that the UNE switching rates are too low

# Comparison of Filed Costs to PSC-Ordered Rates

2-wire Analog Loop (Service Level 1)						
	Recurring Cost			Nonrecurring Cost		
	Filed	Ordered	% Change	Filed	Ordered	% Change
Alabama	\$21.33	\$17.60	-17.5%	\$75.62	\$37.81	-50.0%
Florida	\$18.04	\$15.27	-15.4%	\$83.20	\$49.57	-40.4%
Kentucky	\$23.00	\$18.04	-21.6%	\$75.26	\$46.66	-38.0%
Louisiana	\$21.71	\$17.30	-20.3%	\$75.17	\$36.54	-51.4%
Mississippi	\$28.83	\$23.12	-19.8%	\$75.30	\$37.92	-49.6%
South Carolina	\$22.00	\$17.60	-20.0%	\$75.84	\$37.92	-50.0%

Recurring Cost is statewide average.

Georgia recurring cost modifications discussed later. Nonrecurring costs cut in half.

North Carolina Order pending in current cost docket.

Tennessee Regulatory Authority has not initiated a new cost docket.

# Main Areas of Controversy

**TELRIC has an overarching problem: It attempts to develop costs of a provider in a textbook competitive market while also assuming ubiquitous deployment, something that a competitive firm would never choose to undertake.**

- Network Design – TELRIC Implications
  - Least cost, most efficient network configuration
    - Existing cable routes - ignored
    - Actual vendor mix - disregarded
    - Actual contracts – prices & conditions - disregarded
  - Forward-looking
    - Continually updated and re-evaluated
  - Modeling assumptions questioned
    - Structure Sharing
    - Fill Factors (Utilization)
    - In-plant versus bottoms-up

# Main Areas of Controversy

- Network Design – Realities
  - Flash-cut to forward-looking, least cost, most efficient network ignores the manner in which the network evolves
    - Cable sizes
    - Cable routes
    - Equipment
  - Costs are constantly re-evaluated --- lower costs anticipated by state commissions/CLECs --- ILECs never able to recover even the first artificially low rates before yet lower rates are set

# Main Areas of Controversy

- Cost of Capital
  - Incorrect to view ILEC as monopoly service provider – must capture the manner in which investors would actually value the relevant risks of the ILEC in the competitive market
  - Under TELRIC, cost of capital calculated against a hypothetical, least-cost network --- ILECs never obtain a complete return on actual investment

# Main Areas of Controversy

- Cost of Capital
  - Must reflect increasing risk --- telecommunications market in decline, increased competition for limited capital
    - "At this point, the final impact of UNE-P remains unclear. However, our analysis suggests that the risks to the Bells have increased substantially because of this competitive development, warranting our cautious approach to the stocks, even at these levels." "We believe the results we have outlined above, driven by our analysis of UNE-P, makes a potential downgrade of Verizon's credit rating more likely, potentially increasing borrowing costs and raising risks to equity shareholders." *How Much Pain From UNE-P?*, UBS Warburg, August 20, 2002
    - "[The FCC's Triennial Review decision] Increases capital investment risk and uncertainty." *FCC Decision Accelerates Dis-investment and Shifts Equipment Demand*, Precursor Group, March 4, 2003.

# Main Areas of Controversy

- Depreciation
  - Must recognize that TELRIC pricing methodology inherently builds in obsolescence
    - TELRIC based on forward-looking concepts, yet for depreciation, state commissions rely on old embedded rate-of-return concepts
    - Forward-looking approach requires economic lives

# Main Areas of Controversy

- Nonrecurring
  - Conflict between modeling of forward-looking, most efficient technology and the costs BellSouth actually incurs to provision UNEs
  - Nonrecurring costs erroneously categorized as “embedded”
    - Unattainable provisioning processes envisioned by CLECs
  - Perceived “barrier-to-entry” – thus, substantial real costs not recovered when nonrecurring rates are dramatically reduced to “promote competition”

# Example of State Commission Adjustments

(Georgia PSC's UNE Order – Modifications to Service Level 1 Loop)

- Major input modifications:
  - Cost of Capital
  - Depreciation
  - Structure Sharing
  - Underground Boring - % Activity
  - Splicing/Placing Times
- Arbitrary Adjustment
  - Inappropriate reduction for growth

# Impact of Georgia PSC's Adjustments

2-wire Analog Loop (Service Level 1)	Cost	Difference From Filed	% Difference	
Filed (1)	\$21.98			
<b>Stand-alone Impact</b>				
Cost of Capital	\$19.51	-\$2.47	-11.2%	
Depreciation	\$21.20	-\$0.78	-3.5%	
Structure Sharing	\$20.66	-\$1.32	-6.0%	
Underground Boring (% Activity)	\$21.04	-\$0.94	-4.3%	
Placing/Splicing Times	\$20.65	-\$1.33	-6.1%	
Inappropriate Growth Adjustment	\$18.78	-\$3.20	-14.6%	
<b>Notes:</b>				
(1) The GPSC ordered a bottoms-up submission in place of BellSouth's in-plant factors to calculate the installed investment (EF&I costs). The \$21.98 was calculated using appropriate bottoms-up inputs.				
(2) The final approved statewide average set by the Georgia PSC was \$13.14. Since the modifications outlined above were run individually, the cumulative impact is not reflected. For example the growth adjustment was made after the investment was reduced by other input changes and thus the reduction would be less than shown above.				

# Example of State Commission Adjustments

- Current nonrecurring charges in five states reflect a 50% reduction of BellSouth's costs
  - Nonrecurring costs reflect expenditures that must be paid immediately by the company
  - Forward-looking technology requirement generates unrealistic, unattainable expectations

# Example of State Decisions Inconsistent with FCC Orders

- Commission's UNE Remand Order states: “networks built today normally should not require voice-transmission enhancing devices on loops 18,000 feet or shorter. Nevertheless, the devices are sometimes present on such loops, and the incumbent LEC may incur costs removing them. Thus, **under our rules, the incumbents should be able to charge for conditioning such loops.**” (§193 Emphasis added.)
- This legitimate charge for conditioning loops less than 18,000 feet is set to \$0 in five states in BellSouth's region.

# TELRIC NPRM Objectives

- Provide unambiguous direction to state commissions
  - Resolve common areas of controversy to eliminate inconsistency
  - Bring closure to issues repeatedly raised in state proceedings
- Clarify the TELRIC pricing rules
  - Not ILEC monopoly; operating in a competitive environment
  - Emphasize that purpose is rate setting
- Set an aggressive timetable for states to implement revised pricing rules

# TELRIC NPRM Specifics

- Network Design
  - Define what constitutes forward-looking
    - Emphasize that consideration of real-world constraints does not violate pricing rules
    - Recognize that current pricing rules do not allow ILECs to ever recover costs associated with capital expenditures
  - Specify that the use of actual data (e.g., for fill factors & structure sharing) does not violate TELRIC

# TELRIC NPRM Specifics

- Cost of Capital
  - Ensure impact of risk in a competitive environment is adequately reflected
  - Find cost of capital does not equate to profit
- Depreciation
  - Determine there is a tie between depreciation and TELRIC-induced obsolescence which must be reflected
- Nonrecurring Charges
  - Specify that ILECs are entitled to recover the actual costs associated with provisioning UNEs

Item	Louisiana	Alabama	Florida	Kentucky	Mississippi	South Carolina	Georgia Staff Recommendation
Cost of Capital	10.09%	11.25%	10.24%	10.68%	10.00%	11.25%	9.27%
Depreciation:	FCC-based	BellSouth Proposed	BellSouth Proposed w/exceptions	BellSouth Proposed w/exceptions	MPSC Ordered	BellSouth Proposed	FCC-based prescribed plant lives and depreciation rates for Georgia
Digital Switching	12	10	13	13	17	10	16
Circuit - Digital	11	9	9	9	10	9	10.5
Aerial - Metallic	18	15	18	18	19	15	18
Aerial - Fiber	25	20	20	20	25	20	25
Underground Metallic	25	14	23	23	25	14	23
Underground - Fiber	25	20	20	20	30	20	25
Buried - Metallic	20	15	18	18	20	15	18
Buried - Fiber	20	20	20	20	25	20	25
Shared & Common Factors	Accepted BellSouth methodology, but some modifications made to input. Rejected CLEC argument that the productivity component should be equal to 6.5% and that DUF costs are reflected in the shared & common cost factors.	Accepted BellSouth methodology. Rejected CLEC argument that the productivity component should be equal to 6.5% and that DUF costs are reflected in the shared & common cost factors.	Accepted BellSouth methodology. Rejected CLEC argument that the productivity component should be equal to 6.5% and that DUF costs are reflected in the shared & common cost factors.	Accepted BellSouth methodology. Rejected CLEC argument that the productivity component should be equal to 6.5% and that DUF costs are reflected in the shared & common cost factors.	Accepted BellSouth methodology. Rejected CLEC argument that the productivity component should be equal to 6.5% and that DUF costs are reflected in the shared & common cost factors.	Accepted BellSouth methodology. Rejected CLEC argument that the productivity component should be equal to 6.5% and that DUF costs are reflected in the shared & common cost factors.	Accepted BellSouth's shared & common methodology. Cost of money and depreciation adjustments impact the actual factors.
Inflation	Not an issue	Not an issue	Original order (May 25, 2001) ordered that inflation should be eliminated based on a perceived mismatch between material and demand. This was later reversed in recon order.	Not an issue	Not an issue	Not an issue	Not an issue
Fill Factors	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location; no adjustment for growth.	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location; no adjustment for growth.	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location; no adjustment for growth.	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location; no adjustment for growth.	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location; no adjustment for growth.	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location; no adjustment for growth.	Accepted BSTLM-generated fill, which the model calculates based on current demand and the number of lines placed to each customer location. No adjustment for growth in fill factors.

Item	Louisiana	Alabama	Florida	Kentucky	Mississippi	South Carolina	Georgia Staff Recommendation
In-Plants (Loading Factors)	Accepted BellSouth methodology. Rejected CLEC argument that in-plant factors were embedded and artificially inflate costs.	Accepted BellSouth methodology. Rejected CLEC argument that in-plant factors were embedded and artificially inflate costs.	Accepted BellSouth methodology in May 25, 2001 Order. However, BellSouth was directed to refile loop costs studies which explicitly modeled all cable & associated structure, engineering, installation and placement, which the FPSC used in establishing rates in its September 6, 2002 Order.	Accepted BellSouth methodology. Rejected CLEC argument that in-plant factors were embedded and artificially inflate costs.	Accepted BellSouth methodology. Rejected CLEC argument that in-plant factors were embedded and artificially inflate costs.	Accepted BellSouth methodology. Rejected CLEC argument that in-plant factors were embedded and artificially inflate costs.	Used bottoms-up version of the BSTLM. The BSTLM models loops less than or equal to DS1. The bottoms-up version explicitly models all cable and associated structure, engineering, installation and placement. Accepted in-plants for digital loop carrier and other UNEs. Staff's adjustment to BellSouth's bottoms-up scenario (not including the impact of other adjustments like cost of money and depreciation) resulted in a decrease of 33.5% in the investment for the Service Level 1 Loop. This includes a 14.9% growth adjustment listed below.
Use of DSOs	Accepted BellSouth methodology. Rejected CLEC argument that DLC common equipment and fiber facilities should be allocated based on lines, not DSOs.	Accepted BellSouth methodology. Rejected CLEC argument that DLC common equipment and fiber facilities should be allocated based on lines, not DSOs.	Accepted BellSouth methodology. Rejected CLEC argument that DLC common equipment and fiber facilities should be allocated based on lines, not DSOs.	Accepted BellSouth methodology. Rejected CLEC argument that DLC common equipment and fiber facilities should be allocated based on lines, not DSOs.	Accepted BellSouth methodology. Rejected CLEC argument that DLC common equipment and fiber facilities should be allocated based on lines, not DSOs.	Accepted BellSouth methodology. Rejected CLEC argument that DLC common equipment and fiber facilities should be allocated based on lines, not DSOs.	Changed digital loop carrier capacities so equipment is sized and costs are allocated on shelf space rather than DSOs.
Features	Included in end office switching.	\$1.98	\$2.26	\$0.00	\$2.56	\$3.04	\$0
Deaveraging Methodology	Wire Center	Wire Center	Wire Center	Wire Center	Wire Center	Rate Group	Wire Center
Competitive Adjustments	None	Instead of specifically modifying the cost study inputs, the APSC reduced proposed loop and combination recurring costs by 17.5%, features by 25%, all other recurring costs by 12.5%; nonrecurring by 50% (xDSL NRC by 53%).	None	The KPSC reduced proposed recurring costs by 17.7%	MPSC ordered 10% reduction of proposed loop and combination recurring costs after other adjustments; nonrecurring reduced by 50%.	SCPSC reduced proposed recurring costs of loops and combinations by 20% (DS1 by 30%); all nonrecurring rates by 50%.	None
Inappropriate Adjustment for Growth	Not an issue	Not an issue	None	Not an issue	Not an issue	Not an issue	Adjusted loops less than or equal to DS1 for growth. Reduced investment/cost by 14.9%.

<b>FCC Ranges</b>	<b>Low</b>	<b>High</b>
<b><u>Depreciation:</u></b>		
Digital Switching	12	18
Circuit - Digital	11	13
Aerial - Metallic	20	26
Aerial - Fiber	25	30
Underground Metallic	25	30
Underground - Fiber	25	30
Buried - Metallic	20	26
Buried - Fiber	25	30

2-wire Analog Loop (Service Level 1)	BellSouth Filed Bottoms-up Input	GPSC Ordered	Cost	Difference From Filed	% Difference
Filed (1)			\$21.98		
<b>Stand-alone Impact</b>					
Cost of Capital	11.25%	9.27%	\$19.51	-\$2.47	-11.2%
Depreciation	GAPP	FCC-based prescribed for Georgia	\$21.20	-\$0.78	-3.5%
Digital Switching	10	16			
Circuit - Digital	9	10.5			
Aerial - Metallic	15	18			
Underground - Metallic	14	23			
Buried - Metallic	15	18			
Fiber	20	25			
Structure Sharing			\$20.66	-\$1.32	-6.0%
Aerial	26.43%	26.43%			
Buried	13.33%	30.00%			
Underground	0.03%	20.00%			
Underground Boring (% Activity)			\$21.04	-\$0.94	-4.3%
Urban	12.50%	0.75%			
Suburban	5.75%	0.35%			
Rural	2.67%	0.16%			
Placing/Splicing Times			\$20.65	-\$1.33	-6.1%
<b>Example - based on 25 pair cable (predominate sized cable placed by BSTLM)</b>					
Total set-up and splicing hours - assumes 1 set-up and 25 pairs spliced to 25 pairs					
Aerial CU	1.660	0.165			
Buried CU	3.070	0.980			
UG CU	2.660	1.565			
Growth	Not Appropriate	Based on average switched line growth 1995- 2000	\$18.78	-\$3.20	-14.6%
<b>Notes:</b>					
(1) The GPSC ordered a bottoms-up submission in place of BellSouth's in-plant factors to calculate the installed investment (EF&I costs). The \$21.98 was calculated using appropriate bottoms-up inputs.					
(2) The final approved statewide average set by the Georgia PSC was \$13.14. Since the modifications outlined above were run individually, the cumulative impact is not reflected. For example the growth adjustment was made after the investment was reduced by other input changes and thus the reduction would be less than shown above.					

Year	GPSC Line Count	Actual	Actual Year-Over-Year Change		
1995	3,455,619	3,455,619			
1996	3,687,014	3,687,014	6.70%		
1997	3,919,845	3,919,845	6.31%		
1998	4,139,081	4,139,081	5.59%		
1999	4,289,588	4,289,588	3.64%		
2000	4,264,151	4,264,151	-0.59%		
2001	4,312,000	3,995,600	-6.30%		
2002	4,474,085	3,648,152	-8.70%		
2003	4,642,263				
2004	4,816,762				
Line growth assumed by GPSC:		3.76%			
2001-2004 projected by GPSC.					